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Pass-Through Entities: The Bankruptcy Process Through the Eyes of the Creditor

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I. INTRODUCTION

As Professor Willard Horwich observed in his treatise on bankruptcy tax, "[i]n every active business and complex business society the problems of insolvent and bankrupt business … will be present. Just as death and taxes are the lot for ever person, it would appear that the lot of every bankruptcy situation includes the specter of the tax collector…. Every restructuring of debt brings into play provisions of the Internal Revenue Code."[1] Nowhere is the Internal Revenue Code (the "IRC") more complicated than when Subchapter K intersects with the Bankruptcy Code.

The literature discussing this subject tilts heavily in favor of the treatment (or mistreatment) of *debtors* under the two codes; but it is the rare discussion that shifts that focus to the treatment of partnership creditors. While much of what follows applies to any analysis of a partnership, I have, where appropriate, adopted a creditor perspective. Toward that end, I have broken the discussion into four areas: (i) restructurings and workouts of partnership debt; (ii) restructuring the partnership as part of pre-bankruptcy planning; (iii) bankruptcy tax; and (iv) partnership bankruptcies. None of the discussion is intended to be and is not comprehensive; rather, my goal is to highlight significant substantive areas and their bankruptcy and tax consequences.

II. RESTRUCTURINGS AND WORKOUTS OF PARTNERSHIP DEBT

Before an insolvent partnership contemplates bankruptcy, it will likely attempt to maximize the inherent value a potential insolvency proceeding presents by attempting to restructure its financing obligations, especially if there is a chance the partnership can actually increase cash flow. While a restructuring has multiple commercial and tax consequences, understanding a debtor's alternatives to seeking an order for relief from a bankruptcy court is essential to representing creditors so that the creditor's key weapon – leverage – can be maximized.

[1] Willard D. Horwich, J.D., CPA, *Tax Issues in Bankruptcy and Insolvency*, Civic Research Institute, 2004 ("Horwich"), at p. ix.

A. The Debtor's Alternatives

There are at least two available alternatives to a debtor in lieu of filing for bankruptcy protection: (i) dealing with each creditor separately; and (ii) making assignments for the benefit of creditors (i.e., transferring assets to a third party who undertakes to pay the creditors a proportionate share of the debts without court supervision). Each is briefly discussed below.

1. Arrangements with Individual Creditors

a. Debt Modification

If a debtor has only a few creditors, it may be possible to work-out individual arrangements for installment payments or other settlements. From a legal perspective, it could be fairly simple for a debtor who owes a substantial amount of money to one creditor to make a deal for either term payments or a cash settlement for a discount. However, as is discussed in more detail below, even this informal arrangement has tax consequences. For example, if a debt incurred in the business transaction is settled at discount, the amount of the discount may represent taxable income or a reduction of the purchase price of the goods or property that gave rise to the debt.

b. Tax Consequences to Holder and Obligor

(1) "Modification" of Debt Instruments

If a "modification" of a debt instrument is deemed to be a "significant modification" under the IRC Regulations (hereinafter, the "Regs."), then the holder of the debt will be required to recognize gain or loss as measured by the difference between the fair market value of the new instrument and the basis of the old instrument. There are, of course, consequences to the obligor. Specifically, the obligor will have cancellation of debt income to the extent that the amount of the obligation of the new instrument is less than the amount of the obligation of the old instrument. Additionally, the original issue discount ("OID") rules may be implicated if the values and yields on the face of the debt instrument are altered. It is, therefore, a critical part of the analysis to determine how the Regs. define "modification" and "significant modification."

The Regs. define "modification" as an alteration in any legal right or obligation (including the addition or deletion of a right or obligation) of the issuer or holder of the debt instrument, whether the alteration is evidenced by an amendment of the instrument, conduct of the parties, or otherwise.[2] An alteration that occurs through one party's exercise or waiver of a right granted under the terms and conditions of the financing agreements is a unilateral right and, as such, no modification will be found for purposes of IRC Section 1001.[3]

The exercise of a right is *not* unilateral if:

1. The right is created in the other party to alter or terminate the instrument or transfer it to a third party;

2. The consent of the other party is required; or

3. Such exercise requires a consideration, unless the amount is fixed on the issue date.[4]

In short, if the terms of the instrument itself provide that one of the parties has the right to do something that changes the terms of the instrument, and that right is not dependent upon any action of the other party, the change does not constitute a modification.[5]

(2) "Significant" Modification

Generally, a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.[6]

a. Change in Yield

A change in the interest rate of an instrument may cause a significant modification. And the Regs. provide that a change in the interest that exceeds .25 of .01 % is a significant modification.[7]

[2] Regs. § 1.1001-3(c)(1).
[3] Regs. § 1.1001-3(c)(1)(ii).
[4] Regs. § 1.1001-3(c)(2).
[5] Horwich, at ¶ 6.3[3](a).
[6] Regs. § 1.1001-3(e)(1).
[7] *See* Regs. § 1.1001-3(e)(2).

b. Change in Timing

A deferral of payments or a change in timing of the payments is considered a significant modification if the final maturity date exceeds the lesser of five years or 50 percent (50%) of the original term of the instrument.[8]

c. Substitution of Obligor

The Regs. provide that the substitution of a new obligor on a debt instrument is a significant modification, unless IRC Section 381(a) applies.[9] That section refers to certain carryovers (e.g., NOLs, earnings and profits, and capital loss carryovers) that take place when one corporation acquires the assets of another.

d. Change in Form of Security

The Regs. provide that the addition or material alteration of a guaranty or other form of credit enhancement on a nonrecourse instrument is a significant modification.

e. Change in the Nature of the Instrument

A modification of the instrument is significant if it changes the instrument to a separate and different instrument or to property that is not debt at all for federal income tax purposes. A change in the debt instrument will be found to be significant if:

- A fixed-rate instrument is changed to a variable rate or contingent payment instrument;
- A variable rate instrument is changed to a fixed rate or contingent payment instrument;
- A contingent payment instrument is changed to a fixed or variable rate instrument;
- There is a change in the currency used to pay the instrument;
- There is a change in the conversion or exchange rights of the instrument; or

[8] Regs. § 1.1001-3(e)(4).
[9] Regs. § 1.1001-3(e).

- A term is added to or deleted from the instrument, giving the holder the right to convert into stock of the issuer, if such right has significant value at the time it is added or subtracted from the original instrument.[10]

2. Assignment for the Benefit of Creditors

Dealing with creditors one at a time as the above-described approach contemplates may not be an option for a partnership with multiple creditors. When a single creditor goes to court seeking a writ of attachment or attempts to replevy certain personal property a "race of the diligent" begins, with each creditor jockeying for position and priority. Individual negotiations will no longer be an option. An assignment for the benefit of creditors (an "ABC") may provide a solution.

An ABC is a form of out-of-court liquidation.[11] In short, the assets of the business may be assigned to an individual (or an organization) who takes title to the assets. That individual or organization makes individual arrangements with each of the creditors for payment.

An ABC is an act of bankruptcy under Bankruptcy Code Section 303. Such an assignment, therefore, provides a creditor with the right to file an involuntary proceeding, even though few actually take this step.

The tax consequences of these arrangements are similar to modifications to debts, discussed above.

B. Special Considerations for Partnerships

1. Liability Shifts

There are multiple tax consequences to a partner if partnership liabilities are increased or decreased as a result of a restructuring or modification of liabilities. Specifically, under IRC Section 752, increases in a partner's share of partnership liabilities are treated as deemed cash contributions to the partnership by the partner, and decreases in a partner's share of partnership liabilities are treated as deemed cash distributions to the partner. The partner's basis in its

[10] Regs. § 1.1001-3(e).
[11] Horwich, at ¶ 1.2[3], p. 1-4.

partnership interest is adjusted to reflect these deemed contributions or distributions; the capital accounts, however, are not affected. A constructive cash distribution allocable to a partner is taxable to that partner, to the extent the deemed distribution exceeds the partner's basis in his partnership interest immediately before the distribution.[12] A constructive cash contribution by a partner is not a taxable event to that partner.[13]

In Revenue Ruling 94-4, the IRS ruled that a deemed distribution of money under Section 752(b) arising from a decrease in a partner's share of partnership liabilities will be treated as an advance or drawing of money under Regs. § 1.731-1(a)(1)(ii) to the extent of the partner's distributive share of income for the partnership tax year. The amount treated as an advance or drawing of money is to be taken into account at the end of the partnership tax year rather than at the time of the deemed distribution. More important for our purpose, however, is that Rev. Rul. 94-4 provides that the deemed distributions resulting from debt cancellations may be treated in an identical manner.

2. Admission of Creditor as Partner

Under certain circumstances, a partnership could, in exchange for an agreement to cancel its liability to a creditor, grant an interest in the partnership to the creditor.

a. Consequences to Partnership and Existing Partners

There is little apparent authority as to the tax consequences of the cancellation of partnership debt in exchange for a partnership interest.[14] Assuming that the debt was incurred by the partnership for property under Section 721, e.g., a loan, the conversion of partnership debt into a partnership interest should not result in debt-discharge income to the partnership or existing partners.[15]

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[12] IRC § 731(a)(1).
[13] IRC § 721.
[14] In PLR 8643062, the Service concluded that the cancellation of partnership debt in exchange for an additional interest was a "sale or exchange" under § 708(b)(1)(B).
[15] *See* U.S. Income Series, *Portfolio 541-3d: Tax Aspects of Restructuring Financially Troubled Entities*, at 68; *see also Twenty Mile Joint Venture v. Comr.*, 200 F.3d 1268 (10th Cir. 1999) (the Tenth Circuit, in dicta, noted that absent any authority cited by either the taxpayer or the government, it would assume that a bona fide additional contribution to the capital of a partnership would not have constituted income). Similarly, the cancellation or

b. Consequences to Creditor

In general, a creditor will not recognize gain or loss upon the contribution of partnership debt to the partnership in exchange for a partnership interest.[16] On the other hand, the contribution of an installment note when the partnership is the obligor is a "satisfaction" of such note, resulting in income to the creditor.[17]

c. Planning Point: Controlling For Possible COD Income And Gain to Creditor

As noted above, if an alteration of a debt instrument into equity pursuant to its original terms is not a modification, there will be no cancellation of indebtedness income to the obligor or gain to the holder under IRC Section 1001. Accordingly, it behooves the forward thinking partnership to anticipate a future modification by ensuring that the partnership agreement provides for the admission of a creditor for cancellation of debt and, most important, that the original debt instrument allows for the unilateral conversion of the obligations set forth under the debt instrument to be cancelled in exchange for a partnership interest. In short, under certain circumstances, the alteration of a debt instrument into equity pursuant to its original terms is not a modification and taxable exchange.

Even if a partnership level debt-equity exchange does not avoid cancellation of debt income, the existing partners may be taxed as a result of the liability shift and deemed distribution under Section 752. If the partners recognize gain, the partnership can and should make a Section 754 election to increase the adjusted basis of its assets by the amount of any such recognized gain.[18]

The admission of a creditor as a partner can have additional collateral tax consequences to the existing partners. For example, upon the exchange of a *portion* of nonrecourse debt for a partnership interest, the creditor becomes both creditor and a partner of the partnership.

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reduction of partnership purchase money debt in exchange for a partnership interest should qualify for nonrecognition treatment under Section 721.

[16] IRC § 721.
[17] IRC § 453(b).
[18] IRC § 734(b)(1)(A). The Section 754 election would avoid double taxation of the partners upon a subsequent sale of the partnership property.

Thereafter, the remaining portion of that nonrecourse debt generally is treated as recourse to the creditor/partner under Section 752, shifting the allocation of such debt from existing partners to the creditor/partner and resulting in the allocation of future deductions related to such debt to the creditor/partner.[19] The decrease in the amount of nonrecourse debt also can decrease the partnership minimum gain, requiring the allocation of income to certain existing partners.

3. Net Profits Interest to Creditor

The marketplace has seen an influx of creditors demanding *participation* in future profits as a method to extract value in exchange for a modification of a debt instrument in a restructuring. They will, however, attempt to avoid taking on any liability as a partner in the partnership. One solution has been to grant the creditor a contingent payment based on partnership cash flow or proceeds from sales of assets, i.e., a net profits interest or "NPI," without formal admission as a partner.

a. Status as Creditor

The characterization of a debt instrument with a NPI as debt or equity for federal income tax purposes is unclear because the creditor participates in the profits of the venture in much the same manner as a partner. Although a NPI generally does not create a partnership between the debtor and creditor, all of the facts and circumstances of the arrangement must be examined to determine whether there was an intent to create a partnership. Factors indicative of a partnership are:

- Sharing of profits and losses;
- Sharing of capital;
- Participation in management;
- Performance of substantial services; and
- A partnership agreement.

[19] *See* Regs. § 1.752-2(c), (d); Regs. § 1.704-1(b)(3).

The intent of the parties and the sharing of profits and losses are often cited as the most important factors in this determination. With that said, the Service, in Revenue Ruling 73-374, ruled that the sharing of capital through the co-ownership of property, even with an intent to profit, does not create a partnership for federal tax purposes.

The consequences of the NPI causing a debt to be recharacterized as equity are not insubstantial. First, the creditor is deemed to have contributed the debt to the partnership in exchange for a partnership interest. Second, the partnership will be denied a deduction for payments to the creditor relating to the purported "debt" as interest. Instead, such payments will be characterized as distributions to the partner/creditor. Further still, recharacterization reduces the existing partners' shares of partnership liabilities under Section 752, resulting in a taxable deemed distribution of money.

b. Taxation of Net Profits Interest

The addition of a NPI in connection with a debt restructuring results in a deemed exchange of the old debt for a new (modified) debt instrument for tax purposes. As a consequence, as discussed above, cancellation of indebtedness income could arise for the obligor, gain could be recognized by the holder/issuer, and the new debt must be tested for OID and/or imputed interest.

4. Debt-Discharge Income — Partnerships

a. Generally

Partnership cancellation of indebtedness income is allocated amount the *partners* in accordance with the profit sharing ratios of the partnership agreement and passed through to the partners as a separate item under IRC Section 702(a)(8). Under IRC Section 706(a), the partners must include their distributive share of such income in each partner's taxable year within which the partnership's taxable year ends.[20]

[20] *See* PLRs 9426006 through 9426019.

b. Special Allocations of Discharge Income

If partnership debt is discharged and "specially allocated" to partners that are insolvent, bankrupt or otherwise able to avoid taking the COD into income, the Service may challenge such an allocation under the Section 704(b) Regs. as not having "substantial economic effect." For example, in Revenue Ruling 99-43, the Service concluded that a partnership's special allocation of COD income to an insolvent partner and a corresponding special allocation of Section 704(b) book loss were "shifting allocations" that lacked substantiality. In the ruling, the Section 704(b) book loss arose from the revaluation of the partnership's assets and the special allocation reduced both partners' capital accounts to zero.

c. Special Considerations Under Section 108

(1) Insolvency Computation

In a partnership, a question arises as to whether a partner's insolvency is determined by taking into account the fair market value of the partner's interest, or whether the partner is viewed as owning an undivided interest in the assets and liabilities of the partnership.

One approach is to use the fair market value of the partnership interest, since this is consistent with other tax provisions that treat a partner as owning only its partnership interest.[21]

(2) Purchase-Price Adjustment of Section 108(e)(5)

Under IRC Section 108(e)(5), a reduction to seller financing is treated as a purchase-price adjustment, i.e., basis reduction, and does not result in COD income to the purchaser. This protection is unavailable if the purchaser is insolvent or in bankruptcy at the time of the reduction.[22]

The IRS has applied Section 108(e)(5) at the *partnership* rather than the partner level without regard to the solvency of the partners. For example, in TAM 8429001 and PLR 9037033, the Service ruled that a reduction to seller financing by a solvent debtor/partnership was a partnership level transaction that qualified under Section 108(e)(5). Further, in Rev. Proc.

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[21] *See* U.S. Income Series, *Portfolio 541-3d: Tax Aspects of Restructuring Financially Troubled Entities*, at 78.
[22] IRC § 108(e)(5)(B).

92-92, the Service stated that it will not challenge a bankrupt or insolvent partnership's treatment in this regard if the partner's reported treatment is consistent with the partnership's.

d. Deficit Capital Accounts

A partner's deficit capital account represents the potential liability of the partner to the partnership in the event that the partnership is liquidated at book value. A partner's capital account can be *negative* as a result of a nominal capital contribution followed by substantial loss allocations. A deficit capital account balance may also indicate liabilities in excess of the partner's basis in its partnership interest. Accordingly, any transaction that reallocates the partner's share of partnership liabilities has the potential to cause a taxable event under Section 752.

III. RESTRUCTURING THE PARTNERSHIP AS PART OF PRE-BANKRUPTCY PLANNING

A. Incorporating the Partnership

1. Generally

Incorporating the partnership as part of any insolvency planning is always part of the legal landscape, especially given the complexities of Subchapter K and the Bankruptcy Code. Incorporating the partnership will provide limited liability to general partners, allowing limited partners to participate in management, and may provide increased liquidity for ownership issues and assist in raising equity investment.[23]

The drawbacks of incorporation, however, are not insubstantial. They include so-called "double-taxation," i.e., taxation of corporate earnings at both the corporate and shareholder level, the elimination of the ability to pass-through and to specially allocate losses to shareholders, and an increased likelihood of a taxable event upon liquidation.

[23] IRC § 351 will not apply and provide nonrecognition treatment to a transfer of property of a debtor pursuant to a plan while the debtor is under the jurisdiction of a court in a Title 11 or similar case, to the extent that the stock received in the exchange is used to satisfy the indebtedness of the debtor. *See* IRC § 351(e)(2). A "Title 11 or similar case" is defined in Section 368(a)(3)(A) as a case under the Bankruptcy Code or a receivership, foreclosure, or similar proceeding in a Federal or State Court.

2. Methods

Partnerships are incorporated through one of the following three methods: (1) the partnership contributes assets to a corporation in exchange for stock and assumption of liabilities; (2) the partnership liquidates, and the partners contribute the assets received to the corporation in exchange for stock; or (3) the partners contribute their partnership interests to the corporation in exchange for its stock, followed by a liquidation of the partnership into the corporation.

a. Direct Contribution of Assets By Partnership

Subject to the brief discussion above, a partnership should not recognize gain or loss upon a transfer of its property to and the assumption of its liabilities by a corporation in exchange for "control" of the corporation.[24] The corporation takes a carryover basis in the assets received, and the partnership's basis in the stock received is the same as the transferred assets, reduced by the partnership's liabilities assumed by the corporation.[25]

b. Contributions of Assets by Former Partners

The partnership does not recognize gain or loss for federal income tax purposes upon a liquidating distribution to its partners.[26] The partners will not recognize gain on the distribution, except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.[27] Partnerships with lots of cash, therefore, will want to use another incorporation format. Of course, the subsequent contribution of the assets by the partners to the corporation is controlled by Section 351, and the former partners will recognize gain under Section 357(c), to the extent liabilities exceed the basis of property transferred. This determination is made at the *partner* rather than the partnership level. Accordingly, a partner can contribute additional assets to minimize gain.[28]

[24] IRC § 351.
[25] IRC §§ 362(a) and 358(a), (d).
[26] IRC § 731(b).
[27] IRC § 731 (a).
[28] IRC § 737 is also implicated. That section requires partners who contribute appreciated property to a partnership to include pre-contribution gain in income, to the extent that the value of other property distributed by the partnership to that partner exceeds her adjusted basis in her partnership interest.

c. Transfer of Partnership Interests by Partners

Again, the partners will not recognize gain or loss under IRC Section 351 for any contribution of their partnership interests to a corporation in exchange for its stock. However, as Revenue Ruling 80-323 makes clear, upon a partner's transfer of a partnership interest, the partner's share of partnership liabilities is a liability to which that partner's partnership interest is subject for Section 357(c) purposes. Accordingly, some partners may recognize Section 357 gain on the transfer.

d. Planning Considerations

Section 357(c) is applied such that each transferor in a Section 351 exchange recognizes gain to the extent aggregate liabilities assumed exceed the aggregate basis of all property transferred to the corporation in exchange.[29] As a result, a partner can contribute high-basis property to the corporation and reduce or eliminate gain under this section. The Service may challenge and recharacterize a preincorporation contribution to the partnership as one made to the corporation.[30]

Further, analyzing the availability of non-recognition treatment to a partnership debtor under Section 351 is critical. Attempting to incorporate to avoid partnership bankruptcy issues could have onerous consequences if the insolvency has reached a Title 11 or similar case and the stock received is intended to be used to satisfy partnership debt. The consequence of failing to qualify under Section 351 is that the partnership transfer of assets to the corporation will produce recognized loss (or, rarely, gain), and the partnership's transfer of stock to its creditors in discharge of its debt will produce COD income equal to the difference between the partnership's cost basis in the stock and the amount of debt discharged.

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[29] Regs. §1.357-2(a).
[30] *See* Rev. Rul. 73-16.

IV. BANKRUPTCY TAX — BRIEF OVERVIEW

A. The Basics of the Bankruptcy Code

The Bankruptcy Code is Title 11 of the United States Code. The Bankruptcy Code is divided into the following chapters and then subdivided again within those chapters.

1. Chapter 1 – General Provisions;
2. Chapter 3 – Case Administration;
3. Chapter 5 – Creditors, Debtor and the Estate;
4. Chapter 7 – Liquidation;
5. Chapter 9 – Adjustment of Debts of a Municipality;
6. Chapter 11 – Reorganization;
7. Chapter 12 – Adjustment of Debts of Family Farmers with Regular Annual Income; and
8. Chapter 13 – Adjustment of Debts of an Individual with Regular Income.

Chapters 1, 3 and 5 govern the procedural aspects of a bankruptcy and set forth the rights and obligations of the parties.[31] These chapters apply to all bankruptcy proceedings. Chapters 7, 9, 11, 12 and 13 set forth rules regarding different kinds of bankruptcy proceedings. Chapter 7 governs assets liquidations. Business that need relief from their creditors to reorganize their affairs, to attract new capital, and to continue in business would proceed with a Chapter 11 reorganization bankruptcy.[32]

Bankruptcy courts are courts of equity and, therefore, there is always the possibility based on the facts of the present situation of a favorable result. As such, bankruptcy courts do

[31] *Horwich*, at ¶ 1.1.
[32] *Id.*

what is appropriate under the circumstances seeking always to do what is best for the parties involved.[33]

B. Policy of IRC And Bankruptcy Code

It may come as a surprise to some that the IRC adopts the so-called "fresh start" policy of the Bankruptcy Code for both insolvent and title 11 taxpayers by granting certain exceptions to the general rule the income is realized when a debt is discharged.[34] On the other hand, it may also come as a surprise to some of you that the Bankruptcy Code reigns in that policy by identifying numerous tax claims not subject to the discharge in a debtor's chapter 7 or chapter 11 case.[35]

C. Cancellation of Indebtedness Income

In general, the debtor realizes debt-discharge income at the time a debt is repurchased or satisfied for less than its outstanding balance.[36] The Supreme Court established this rule in *United States v. Kirby Lumber Co.* There, the corporate taxpayer purchased its own bonds at a discount on the open market. The Court held that the taxpayer realized income to the extent the issue price for the bonds exceeded the price paid for the reacquisition of those bonds. Section 61(a)(12) of the IRC provides that gross income includes "income for the discharge of indebtedness. Case law provides that COD income may result from complete or partial forgiveness of debt,[37] the modification of the terms of indebtedness, or the foreclosure of property subject to recourse debt.

Identifying the debtor can become complicated when several parties are jointly liable for the same debt. The issue has tax significance for various reasons, including the allocation of debt-discharge income and the reduction of tax attributes and insolvency determination under Section 108. One commentator has suggested that a reasonable approach would include looking

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[33] *Id.*

[34] Jack F. Williams, *Rethinking Bankruptcy and Tax Policy*, American Bankruptcy Institute Law Review, Spring 1995 ("Williams"), at 170.

[35] *Id.*

[36] *Slavin v. Comr.*, T.C. Memo 1989-208 ("A taxpayer has been forgiven or released from a debt when the facts reasonably establish that the debt will probably never be paid, that the taxpayer does not intend to repay the loan, and that the party who loaned he money does not intend to enforce its claim against the taxpayer."

[37] *See Comr v. Jacobsen*, 336 U.S. 28, 38, 40 & n. 7 (1949) (repurchase of secured bonds at prices below that at which they were sold generated gain attributable to taxpayer's income).

at state law to determine the legal relationship between the co-obligors, taking into account equitable concepts such as the right of contribution among co-obligors.[38] This is the approach taken under IRC section 752 in the partnership area. Although a debtor generally realizes income to the extent it is relieved of an obligation to repay a debt, Section 108 of the IRC provides statutory relief from recognition for debtors under certain circumstances.

Under section 752, a partner shares in recourse liabilities to the extent of her economic risk of loss, i.e., the amount that the partner would have to pay when the liability is due reduced by any reimbursements which the partner would be entitled to receive from other partners.[39]

D. Treatment of Cancellation of Indebtedness Income Under IRC Section 108

The Bankruptcy Tax Act and its amendments changed section 108 to provide that a taxpayer's gross income would not include amounts realized from the discharge of indebtedness when: (i) the discharge occurs in a title 11 case; (ii) the debtor is insolvent immediately before the discharge; the indebtedness is "qualified farm indebtedness;" or (iv) the indebtedness is considered "qualified real property indebtedness."

E. Tax Litigation in Bankruptcy

The taxing authority is the ultimate creditor in bankruptcy. And Code Section 505 provides that the bankruptcy court may determine the amount or legality of any tax, fine, tax penalty, or any addition to tax, even if the tax has previously been assessed or paid. The bankruptcy court may also determine (i) the amount or legality of any tax previously adjudicated if the time for appeal has not expired, and (ii) the amount of any tax refund due to the debtor.

The Service must file a claim for any taxes that it claims a debtor owes. Code Section 501(a) provides that any creditor – including the IRS – may file a proof of claim. Most bankruptcy proceedings provide for a bar date that requires claims to be filed within a certain period after the first meeting of creditors. Generally, the bar date is 90 days from the 341

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[38] U.S. Income Series, *Portfolio 541-3d: Tax Aspects of Restructuring Financially Troubled Entities*, at 4.
[39] *See* § 752; Regs. §1.752-2(b). The regulations assume that all partners will actually perform all obligations to make payments, irrespective of their actual net worth. Regs. § 1.752-2(b)(6).

hearing, i.e., the first meeting of creditors.[40] In Chapter 11 proceedings, the bankruptcy court will set the time for the filing of proofs of claim.

Contested and Adjudicated Tax Claims

If a tax matter has been contested and adjudicated before a bankruptcy petition is filed, the bankruptcy court does not have jurisdiction to re-determine the tax. Thus, if a taxpayer files a petition in the Tax Court, defaults, and does not appear at trial, the petition will be dismissed and the bankruptcy court would retain jurisdiction because the prior tax proceedings were not contested.

F. Chapter 11 Reorganization Discharges

A Chapter 11 allows for adjustment of debts of a continuing business operation. Confirmation of a plan under Chapter 11 will discharge the debtor from any debt that arose before the date the plan is confirmed, including tax liabilities.[41] Under this circumstance, the interests of the debtor and its creditors are aligned – against the Service. In short, the lower the tax liability, the more that will be available to the creditors and, ultimately, to the debtor.

1. Tax Requirements of Reorganization Plan

Bankruptcy Code Section 1129 establishes certain requirements with respect to different kinds of debts affected by a confirmed plan. So that the Service cannot be taken advantage of by other groups of creditors working in collaboration with the debtor, allowed tax claims must be paid in full. This does not mean that payment in full in cash is required at the time of confirmation of the plan. Tax claims filed pursuant to the gap liability provisions of Bankruptcy Code Section 507(a)(2),[42] however, must be paid in cash at the time of confirmation of the plan; but priority claims under Section 507(a)(8) may be paid over a period of up to six years after the assessment date.[43]

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[40] Bankr. Rule 3002.

[41] 11 U.S.C. § 527(a)(3).

[42] The "gap" period is, in an involuntary case, a claim arising in the ordinary course of the debtor's business after the commencement of the case but before the earlier of the appointment of a trustee and the order for relief.

[43] 11 U.S.C. § 1129(a)(9)(B).

Where the Service has a prepetition filed notice of tax lien, the plan of reorganization will be subject to the requirements of Bankruptcy Code Section 1129(b)(2). That section requires that the plan provide:

> (i) The property securing the lien will continue to secure the lien, even if transferred to another entity; and the deferred cash payments will total at least the amount of the allowed claim as of the effective date of the plan of the value of the holder's interest in such property;
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> (ii) If the secured property is to be sold, the proceeds of the sales will be subject to the lien; and
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> (iii) The holder of the secured claim shall receive the indubitable equivalent of such claim.

Oft litigated issues include whether the plan unfairly discriminates against the Service or whether the Service is receiving the indubitable equivalent of its claim.

2. Treatment of Secured Tax Claims

If the liability for unpaid taxes has been assessed and recorded, the government will be in a secured position. In a Chapter 11, the contest is between the taxing authority that has a nonpecuniary loss tax lien and the administrative claimholders. Administrative claimants have first priority in liquidation and payment. Further, under Bankruptcy Code Section 1122(a), administrative claims must be allocated to a separate class of claims.

V. PARTNERSHIP BANKRUPTCIES

A. IRC Section 1399

Under IRC Section 1399, the filing of a bankruptcy by a partnership does not create a separate taxable entity for federal income tax purposes. As a result, the partnership's tax attributes are unaffected by the bankruptcy filing; partnership income and loss continue to pass through to the partners under the usual partnership rules. In general, debt discharge income is recognized as partnership income and, thus, flows through to the partners. The debt discharge exceptions of section 108 are then applied at the individual partner level.

There are two justifications for this treatment. First, since these legal fictions are not flesh and blood, any rallying cry for a fresh start rings hollow.[44] Second, there is no separation of postpetition income from the estate in non-individual debtor cases.[45]

B. Miscellaneous Creditor Issues In A Partnership Bankruptcy

1. Jurisdiction Over Partnership's Individual Guarantor

Creditors want to maximize value with little expense. This often requires legal action on individual guarantees of nondebtor general partners. A bankruptcy court, however, lacks subject matter jurisdiction over a suit commenced by a creditor of a Chapter 11 partnership against such a guarantor who guaranteed partnership debts. What is more, provisions as to retention of jurisdiction contained in a confirmed plan of reorganization of the debtor partnership and a consent to jurisdiction provision in the personal guarantee agreements are insufficient to confer jurisdiction.[46]

2. Jurisdiction Over a Debtor General Partner's Assets Used By A Nondebtor Partnership

A general partner's interest in property may be administered and sold in a bankruptcy proceeding despite such property's use by and connection with the partnership.[47]

C. Modification of Partnership Agreement Under a Chapter 11 Plan

There is a split of authority as to whether a plan may modify an existing partnership agreement.

1. Modification Prohibited

In *In re Sovereign Group*, 88 B.R. 325 (Bankr. D. Colo. 1988), the sole general partner of a limited partnership debtor contested a proposed plan which provided for the replacement of the general partner with an affiliate of a special limited partner of the partnership. The Chapter 11 trustee asserted that the partnership terms were not controlling and Bankruptcy Code Section 1123(a)(5)(1) permitted a new partnership arrangement. The court rejected this

[44] Williams, at 183.
[45] *Id.*
[46] *In re Notchcliff Assoc.*, 139 B.R. 361 (Bankr. D. Md. 1992).
[47] *See In re Matter of Woolston*, 147 B.R. 279 (Bankr. M.D. Ga. 1992).

argument and sought to "uphold the sanctity of partnership agreements" and, therefore, strictly applied Section 1123(a)(5)(1) and limited its application to corporations.

2. Modification Permissible

In *In re Ingelside Associates*, 136 B.R. 955 (Bankr. E.D. Pa. 1992), the proposed plan provided that (i) if a partner failed to contribute to a capital call his interest in the partnership would be eliminated and (ii) authorized partners could execute documents on behalf of the partnership as a whole. The court rejected an objection to the plan based upon *In re Sovereign Group* that the foregoing provisions wrongly altered the partnership agreement. Instead, the court specifically found that those provisions were not "so substantial or unfair" as to justify denial of plan confirmation under Section 1129(a)(1) or (a)(3).

D. The New Value Exception to the Absolute Priority Rule

1. Retention of Partnership Interest Permitted

In *In re River Village Assoc.*, 1993 Bankr. LEXIS 870 (Bankr. E.D. Pa. June 25, 1993), the court permitted the debtor's partners to retain their interest in the debtor in consideration for their making a $350,000 contribution to be used for renovations of the debtor's property. It specifically found that the new value exception was met because the contribution was necessary to the reorganization, it was in cash, and it was reasonably equivalent to the interest being retained. The court further observed that since the debtor had no equity in its real property, the debtor's partners would receive "no interest of any real value in exchange for their substantial monetary contribution."

In *In re F.A.B. Indus.*, 147 B.R. 763 (C.D. Cal. 1992), the court identified five requirements to uphold the new value exception in a particular case. The new value must be:

1. New;

2. Necessary for an effective reorganization;

3. Reasonably equivalent to the interest being received;

4. substantial; and

5. In money or money's worth.

2. Retention of Partnership Interest Not Permitted

Some courts have not been nearly as magnanimous. In *In re Bryson Properties, XVIII*, 961 F.2d 496 (4th Cir. 1992), the debtor's proposed plan provided that the debtor's partners would make a cash contribution to the debtor of $625,000 and extend a line of credit of $850,000. In return, the partners would retain their interest in the partnership. In addition to the exclusive right to contribute, the partners under the plan were entitled to a return of their new capital prior to the undersecured creditor recovering on its unsecured claim. All creditors under the plan were to be fully paid except for the undersecured creditor.

The Fourth Circuit found this offer of new value insufficient to make the proposed plan fair and equitable and permit its confirmation. The court was troubled that the partners were in effect allowed to buy the debtor's property without exposing it to the market or otherwise allow any party, including the unsecured creditor, the opportunity to bid for it. The absolute priority rule was not met because the partner's exclusive right to contribute constituted "property" under Bankruptcy Code Section 1129(b)(2)(B)(ii) which was received or retained on account of a prior interest.

The court further found that the new value exception, if it did survive the enactment of the Bankruptcy Code, could not be applied in the case: "[E]ven if some limited new capital exception were viable under the Bankruptcy Code, it would not be so expansive as to apply under the facts of this case. A plan must be fair and equitable in a broad sense, as well as in the particular manner specified in 11 U.S.C. Section 1129(b)(2). Here, debtors have carried their opportunity for self-dealing too far." *See also In re ROPT Ltd. Partnership*, 152 B.R. 406 (Bankr. D. Mass. 1993) (secondary contributions were so discretionary as to have no value where plan provided that partners would contribute $20,000 on effective date of plan and thereafter were required to contribute up to $100,000 more but only if the reorganized debtor, whom they would control determined that additional investment was necessary).

E. Committee of Unsecured Creditors

Perhaps the greatest mechanism for leveling the playing field in a Chapter 11 bankruptcy proceeding is the Bankruptcy Code's allowance of the formation and appointment of a committee of unsecured creditors. Such a committee exists to maximize the return to unsecured creditors and, in some ways, to "bird-dog" the debtor partnership's creation of a plan of reorganization.

1. Section 1102 – Appointment

Section 1102(a)(1) provides for the appointment of an unsecured creditors' committee by the U.S. Trustee as soon as practicable after the order for relief is entered.[48] One court has held that the appointment of a single creditors' committee is the "normal and statutorily prescribed method for assuring representation of all unsecured creditors in a chapter 11 case" and, therefore, appointment of an additional committee is an extraordinary remedy.[49]

a. Adequate Representation

"Adequate representation" will be found where diversified interests of various groups of creditors are represented on and have participated in the original committee appointed by the U.S. Trustee,[50] or where economic interests of various creditors are aligned.[51]

b. Membership on Committee

Ordinarily, a creditors' or equity security holders' committee consists of those persons willing to serve that hold the seven largest claims against the debtor or the seven largest amounts of equity securities of the debtor.[52] Section 1102(b) provides that only "persons" are qualified to serve as committee members. The term "person" is defined in section 101(41) of the Bankruptcy Code and includes only those that are individuals, partnerships and corporations. Governmental entities are generally ineligible to serve unless the governmental unit "acquired an asset from a person as a result of operation of a loan guarantee, or as a receiver or liquidating agent of a

[48] 11 U.S.C. § 1102(a)(1).
[49] *In re TWA, Inc.*, 22 BCD 1236, 1237 (Bankr. D. Del. 1992).
[50] *See In re TWA, Inc.* 22 BCD at 1237.
[51] *see In re Leap Wireless International, Inc.*, (Bankr. S.D. Cal. 2003) (holding that economic interests of equity holders seemed to be aligned with those of bondholders, such that existing committee could adequately represent equity holders' interests).
[52] *See* U.S.C. § 1102(b).

person."[53] A creditor can serve on a committee even if its claim against the debtor is disputed and/or subject to litigation.

A competitor of the debtor who is also a creditor may serve on the creditors' committee notwithstanding the fact that the competitor/creditor may receive confidential information because members of committees have a fiduciary duty and other forms of protection can be implemented, such as requiring the committee member to sign a confidentiality agreement or the entry of a protective order.[54]

2. Challenges To Membership

A party in interest, including the debtor, may challenge the composition of a committee and has the burden of proving that the appointment of the creditor will be detrimental to the debtor's efforts to reorganize.[55]

3. Fiduciary Duties

A creditors' committee owes no fiduciary duty to the debtor or its estate. Rather, its fiduciary duty is to all creditors represented by the committee.[56] The most obvious fiduciary duty is to avoid using its position to further self interest.[57] Once a creditor joins a creditors' committee member, its fiduciary obligations may constrain its behavior from that which might otherwise be permissible.[58]

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[53] *See In re Gates Eng. Co.*, 104 B.R. 653 (Bankr. D. Del 1989) (State of Tennessee held ineligible to serve as a committee member because it was a governmental unit and not a "person" for purposes of section 1102).
[54] *See In re Map Int'l Inc.* 105 B.R. 5 (Bankr. E.D. La. 1989); *In re Microboard Processing, Inc.*, 95 B.R. 283 (Bankr. D. Conn. 1989); *In re Wilson Foods Corp*., 31 B.R. 272 (Bankr. W.D. Okla 1983) (court refused to appoint debtor's competitor on creditors' committee since the creditor would inevitably face a conflict between the interests of its own stockholders and the debtor's creditors).
[55] *See In re Map Int'l, Inc.*, 105 B.R. 5 (Bankr. ED. Pa 1989); *In re Plant Specialties, Inc.* BLD & 71,053 (Bankr. W.D. La. 1986); *See also In re Penn-Dixie Indus., Inc.*, 9 B.R. 936 (S.D. N.Y. 1981) (debtor had standing to challenge equity security holders membership on committee where the equity holder stated its intention to use confidential information to obtain control of the debtor).
[56] *See In re Barney's Inc.*, 197 B.R. 431 (Bankr. S.D. N.Y. 1996).
[57] *See In re Nationwide Sports Distributors, Inc.* 227 B.R. 455, 464 (Bankr. E.D. Pa. 1998).
[58] *Id., at* 464.

4. Section 1103 – Powers and Duties of Committees

a. Selection of and Authorization to Employ Professionals

Under Section 1103(a) of the Bankruptcy Code, a committee can select and employ one or more attorneys, accountants, or other agents to represent or perform services for the committee. Such selection and authorization is to take place at a scheduled meeting of the committee, at which a majority of members of the committee must be present. Such selection, of course, requires court approval.

The terms and conditions of employment and compensation to be paid to professionals retained to represent a committee are governed by the limitations on compensation of all professionals retained in a debtor's case under Section 328, the provisions for compensation of officers under section 330, and the provisions for interim compensation under section 331 of the Bankruptcy Code.

b. Statutory Functions of Committee

Section 1103(c)(1) through (5) list the functions of a committee and provides that the committee may:

- Consult with the trustee or debtor-in-possession concerning the administration of the estate;
- Investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business, and the desirability of the continuance of such business, and any other matter relevant to the case or the formulation of a plan;
- Participate in the formulation of a plan, advise those represented by the committee of such committee's determination as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;
- Request the appointment of a trustee or examiner under Section 1104 of Title 11; and

- Perform such other services as are in the interest of those represented.[59]

The role of a committee in a Chapter 11 case necessarily depends upon the facts and circumstances of a particular case.[60] Although the Bankruptcy Code enumerates a committee's duties, the parameters of a committee's role in a chapter 11 case have been established by case law, and Section 1103(c)(1) authorizes a committee to "consult with" the debtor, but does not authorize it to operate the debtor's business.[61] The committee's most important function - beyond all others – is to negotiate the terms of a plan of reorganization.[62]

5. Appointment of Committee of General Partners – National Bankruptcy Review Commission Recommendation

The National Bankruptcy Review Commission (the "NBC") observed that "[s]ince the 1978 Bankruptcy Code, the use of partnerships as well as the partnership form has changed substantially and the Bankruptcy Code does not adequately address the complex issues that can arise when a bankruptcy petition is filed by or against a partnership."[63] To address the embedded deficiencies of the Bankruptcy Code in the partnership context, the NCB issued a series of proposals setting forth broad principles representing a comprehensive framework to deal with partnership bankruptcies. A copy of the NCB's recommendations is attached hereto as Appendix A.

One such recommendation includes allowing a court, upon a request by a party in interest, to appoint a committee of general partners under Chapter 11.[64] The NCB observed that Chapter 11 authorizes the appointment of a committee of creditors and, upon the request of a party in interest, a committee of equity security holders. It also acknowledged that "[a] fundamental committee formation consideration is whether a particular committee is more likely to accelerate or impede the reorganization process."[65] It then noted that its view on a

[59] 11 U.S.C. § 1103(c).
[60] *See In re Structurlite Plastics Corp.,* 91 B.R. 813, 819 (Bankr. S.D. Ohio 1988); *see also In re Pierce*, 237 B.R. 748 (Bankr. E.D. Ca. 1999) (discussing "significant" duties of an unsecured creditors committee in a chapter 11 case).
[61] *Id.*
[62] *In re Structurlite Plastics Corp*., 91 B.R. at 819.
[63] National Bankruptcy Review Commission — Partnerships, http://govinfo.library.unt.edu/nbrc/report/11partner.html, at 6.
[64] *Id*., at 24, § 2.3.12.
[65] *Id*.

discretionary formation of a committee of general partners diverged from the ABA Ad Hoc Committee's recommendation.[66]

The ABA AD Hoc Committee recommended *mandating* the appointment of a general partners' committee. The NCB suggested, by contrast, a more permissive view, one that provided the court substantial discretion to appoint a committee but did not require that such a committee be formed.[67] The NCB's rationale was based, in part, on the fact that interests of general partners have historically been represented through the formation of unofficial committees.[68] It also acknowledged that a committee of general partners can, in certain circumstances, facilitate the collection of partnership receivables and other assets of the business.[69] The NCB did note that a partnership committee could aid in the determination of appropriate allocations with respect to the liability of the general partners for the deficiency of partnership assets to pay partnership debts.[70] Moreover, the NCB found that the "uniqueness of problems arising in partnership cases which involve a large number of general partners renders a committee of general partners especially suited to facilitate the resolution of differences and disputes with the partnership, among the partners themselves, and with the partnership creditors."[71] But it stopped short of recommending mandating the appointment and status of a committee of general partners in an effort to retain the Bankruptcy Code's flexibility and the court's ability to determine for itself whether the appointment of a committee actually will facilitate or impede the reorganization process, and whether the benefits outweighed the concomitant expenses.[72]

VI. CONCLUSION

In any partnership bankruptcy, the intersection between Subchapter K and the Bankruptcy Code will increase complexity and uncertainty. Understanding the commercial and tax issues that arise in the insolvency context of these flow-through entities will help the

[66] *Id*.
[67] *Id*.
[68] *Id*.
[69] *Id*.
[70] *Id*.
[71] *Id*.
[72] *Id*.

practitioner navigate the seamless web of issues likely to be confronted both before insolvency strikes and after an order for relief is entered.

TABLE OF CONTENTS

TABLE OF CONTENTS
(continued)

TABLE OF CONTENTS
(continued)

Page

TABLE OF CONTENTS
(continued)

Page

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